

APPENDIX

NOTES FOR FOMC MEETING
August 24, 1982

Sam Y. Cross

Today, the level of the dollar is little changed against the major currencies of Europe and Japan from the levels existing at the time of your last meeting. There have been wide swings during the period--the dollar declined by about 5 percent during the second and third weeks of July, then rose by 5-7 percent until mid-August, to 5-year highs against some currencies, and has declined somewhat again since then, to levels close to those on July 1.

But perhaps the most notable feature of the exchange markets in recent weeks is that the dollar has remained in quite strong demand even though U.S. interest rates have declined very sharply, and much more sharply than interest rates in other countries. The strength of the dollar in these circumstances contrasts with several earlier occasions when more modest interest rate downturns have generated substantial dollar selling.

The reduction in interest rate differentials has been striking: U.S. rates, particularly short-term, have declined sharply throughout the period, and the three-month Euro-dollar rate has declined by 5-1/2 percent. Meanwhile, Euro-DM and Euro-Swiss franc interest rates have declined by only about 1 percent, and the Euro-yen rate has actually increased slightly. Thus, interest differentials have declined by almost 5 percentage points against the DM and Swiss franc, and even more against the yen.

The question is why has the dollar remained so strong in the face of declining interest rate differentials. Part of the answer appears to be that for the first time in many months, concerns over

worldwide liquidity and political problems have become a more dominant cause of exchange rate movements than interest rates. There is an increased demand for dollar liquidity related to various financial difficulties affecting international markets. Some of these difficulties affect banks and corporations: the shortages of the Ambrosiano group, the downgrading of bonds of the Canadian banks, and the problems of Dome Petroleum and the receivership of AEG-Telefunken. Others relate to the debt problems of various countries, including several in Eastern Europe and Latin America. Although some of the problems involved U.S. institutions, the feeling has prevailed in the market that the U.S. economy and U.S. institutions would be in the best position to cope with such financial strains.

Another part of the explanation of the strong dollar may be that gloomy economic news from Western Europe and Japan, where production declines have continued and unemployment is still rising, has strengthened expectations that foreign interest rates will be lowered following the declines here. Market participants are predicting reductions of up to 1 percent this week in the German Bundesbank's official lending rates, and a similar move in the United Kingdom.

An additional factor that may be helping the dollar is that the U.S. current account, which had been expected to deteriorate this year because of the high dollar, now appears likely to remain fairly strong, while earlier optimistic forecasts for some other countries' current surpluses have been further scaled back.

Also we have heard reports of foreign investment flowing into the U.S. securities markets, participating in the recent rallies in these markets, although we do not have information that tells us how

much of this investment may be coming out of foreign markets and currencies as opposed to other U.S. instruments.

I might also point out that the price of gold has been rising by \$10-\$15 a day for the past week and today is trading at about \$411. Partly this is attributed to low interest rates but it may also be a reflection of the concern about problem companies and situations and an indication that inflationary expectations have not fully been laid to rest.

Intervention was generally light during the period with the exception of operations by the bank of Canada and the Bank of Japan. The Japanese central bank sold _____ to support the yen, nearly all of it in the first two weeks of August. The Bank of Canada, on the other hand, has been able to add _____ to its net reserves during July and August so far, making purchases in the market while the Canadian dollar strengthened some 3-1/2 percent. The Bank of France also sold _____ equivalent, about evenly divided between dollars and German marks, when the French franc came under pressure last week.

On one occasion early this month when upward pressures on the dollar were quite intense, the Trading Desk intervened on behalf of the System and the Treasury to purchase modest amounts of marks and yen. The operation helped quiet the markets and the dollar subsequently eased back. A Treasury spokesman later confirmed publicly that the intervention had taken place, but did not reveal the date or other details.

The Bank of Mexico made two drawings on its swap line with the Federal Reserve during that period. The first, like earlier drawings at end-April and end-June, was granted to assist in satisfying month-end requirements for reserve backing for domestic

note issue. It was made on July 30 and repaid on August 1. The second was made on August 4 to mature in three months. On August 16, the Bank of Mexico began drawing on a temporary \$1 billion swap facility arranged with the U.S. Treasury over the preceding weekend, and through yesterday had made drawings totaling \$780 million. These drawings are due to be repaid and the facility to expire on August 24, when Mexico is to receive advance payment from the U.S. Department of Energy for oil purchases for the U.S. strategic oil reserve.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
AUGUST 24, 1982

Desk operations since the early July meeting were conducted against a background of weak growth in narrow money supply, a sluggish economy, and a market atmosphere laden with concern over the strength of the financial system. The result was a sharp decline in interest rates, especially in the final portion of the period. The discount rate was cut in three steps of 1/2 percentage point, to 10 1/2 percent, confirming and augmenting somewhat the rate declines.

In a market still apprehensive after the mid-May collapse of Drysdale Securities and the smaller scale demise of Comark in June, the July 5 failure of Penn Square Bank had particularly wide repercussions. While Penn Square was only a medium sized bank, it had sold a substantial volume of energy related loans, now regarded as weak, to other banks, notably Continental Illinois. Continental soon began to have difficulty in the CD market, culminating in its decision to acknowledge that its CDs could no longer trade in the top-tier group of major money market banks. The market was not yet calmed from earlier disturbances when another non-reporting dealer firm, Lombard-Wall, filed for bankruptcy, naming Chase Bank among its unsecured creditors. Chase, already hit with a heavy loss from Drysdale

and a smaller involvement with loan participations from Penn Square, also began to experience some difficulty with its CD funding, though to a lesser degree than Continental. The Lombard-Wall incident is also having repercussions on the repurchase agreement mechanism as a vehicle for short-term financing and investment arrangements. Finally, near the close of the period, rumors swept the market of heavy losses at major U.S. banks due to exposure to Mexican loans--causing a rush of demand for Treasury bills and a temporary shying away from private short-term paper. So far, the U.S. banking and financial system has been resilient enough to weather the storm, but market participants are understandably frayed around the edges.

At the July meeting, the Committee set June-to-September growth objectives of 5 and 9 percent, respectively, from M1 and M2. As a bulge was expected in M1 in July because of the tax cut and social security increases, the reserve growth path was based on M1 growth of about 7 percent in July and 2 1/2 percent in August, while the M2 path was paced more evenly at around 9 percent. As the period progressed, estimates of M1 growth in July were steadily reduced, and indeed the data now show a slight decline for the month. M1 growth resumed in August but the level remained below path. M2 grew just about on path in July and appeared to be pushing above path in early August.

Reflecting the weakness in M1, demand for total reserves ran below path in both of the four week subperiods of the intermeeting interval--by about \$80 million in the first subperiod and an estimated \$230 million in the second subperiod. Because of the shortfall, there were some upward adjustments in the nonborrowed reserve path to encourage a readier availability of reserves and likelihood of an early return to path. In making weekly path adjustments, in the fragile financial market atmosphere, predominant attention was given to the weaker-than-path performance of M1, while a more accommodative attitude was taken toward the relatively strong performance of M2.

The result of the weakness in demand and the various path adjustments was an implicit discount window borrowing gap that narrowed from the Committee's initial \$800 million level to around \$300 million in the final weeks. Actual borrowing fell irregularly from nearly \$1 billion in early July to around the expected \$300 million level in mid-August. With borrowing needs reduced and the discount rate cut in three 1/2 point steps, the Federal funds rate fell off from over 14 1/2 percent in late June-early July to about 10 percent in the latest full statement week and an average of 8.87 percent so far in the current week. Since the latter part of July, as the discount rate was moved down, the funds rate was often below the discount rate, even though borrowings were at a level that would have suggested funds trading at or slightly above

the discount rate. This may have reflected the psychological momentum of rate declines that bred expectations of further official rate cuts and market rate declines. Also, some significant part of the borrowing was seasonal or was being done by banks that may have had problems that limited their access to the funds market.

There were substantial outright operations as reserves ebbed and flowed from market factors during the period. Early in the interval, the System was a heavy outright buyer, meeting seasonal reserve needs with purchases of \$1 billion of Treasury coupon issues and \$1.9 billion of bills. Indeed, at one point early in the period, the Desk had nearly exhausted the intermeeting leeway for outright purchases. From mid-July to early August, the System sold about \$1.7 billion of bills, nearly all to foreign accounts, and ran off \$600 million bills in auctions. Since early August, the Desk turned again to providing reserves, buying about \$1.7 billion from foreign accounts. Finally, in yesterday's bill auction, we turned again in anticipation of later needs to absorb reserves and ran off \$200 million bills. All told, outright securities holdings were increased by a net of about \$2.1 billion on a commitment basis.

Repurchase agreements were employed frequently, either on behalf of the System, or in passing through some of the foreign official account orders to the market. Starting in August, the Desk began to include accrued interest in the

valuation of securities under repurchase agreement contracts. We are strongly encouraging the dealer market to adopt this approach as a general practice in order to avoid the pricing distortions that facilitated the Drysdale incident. As reported to the Committee earlier, we also changed our pricing practice on matched sale purchase transactions, beginning June 30, so that the price of the securities corresponds more closely to their market value.

Interest rates fell sharply and across a broad front during the period, with the greatest declines, as usual, in short maturities--but quite substantial declines in longer issues too. Behind the drop were the weak growth of narrow money supply, soft loan demand, sluggishness of the economy, and market perceptions that the central bank was at least accommodating and to some degree encouraging, the lower rate trend. A particular burst of market exuberance followed reports that well regarded market analysts, who had previously clung to a bearish rate outlook, had changed their minds and now foresaw a weak economy and declining rates in coming quarters. Passage of the tax reform measure near the end of the period was also a plus factor, though other events seemed to overshadow its immediate impact. Through it all, astonishingly, the Treasury raised some \$32 billion--about evenly divided between bills and notes.

Bill rates fell about 3 1/2-5 1/2 percentage points over the interval, with an extra downward push near the end

of the period reflecting flight-to-quality considerations. Three- and six-month bills were auctioned yesterday at about 7.75 and 8.99 percent, respectively, compared with 13.27 and 13.42 percent shortly before the last FOMC meeting. Rates on non-government paper also plunged--some 5 or 6 percentage points on commercial paper, and similarly for major money market bank CDs--though with some of the previously top-tier banks showing less of a decline. The prevailing bank prime rate fell in several steps from 16 1/2 to 13 1/2 percent.

Intermediate-term Treasury issues--2 to 10 years--were down about 2 or 3 percentage points in yield and longer-term issues were off about 1 3/4-2 percentage points. There was occasional temporary indigestion as the market took down large issues from the Treasury, but in time the bulk of the dealers' takings moved out to investors, and largely at rising prices. Dealer holdings of over-1-year Treasury maturities, including an allowance for futures and forwards, rose from around \$2 billion at the end of June to \$4.4 billion on August 20. A two-year note is to be auctioned tomorrow, raising around \$2 billion. Latest estimates suggest a yield near 11 1/2 percent, compared with 13.09 and 14.43 one and two months earlier.

The corporate and municipal markets saw rate declines roughly parallel to Treasury issues, or somewhat

smaller, depending on the measure used, with a rising volume of corporate issues toward the end of the period.

At this point, market participants are wondering whether recent rate declines have been overdone. There was already some disappointment last Friday that another discount rate cut was not announced. Among shorter maturities, normal relationships suggest that rates could back up some, as 9 percent Federal funds and 7 1/2 percent 3-month bills seem scarcely sustainable with the present discount rate and a borrowing level around \$300 million. The trend for longer maturities is harder to gauge, but if short rates backed up appreciably, at least some temporary impact seems likely in the intermediate and longer sectors as well. And the market is bound to remember the Treasury's needs again before long.

James L. Kichline
August 24, 1982

FOMC Briefing

Since the last meeting of the Committee the signs of an expected recovery in economic activity generally have not materialized. Consumer spending has been weaker than projected, liquidation of excess inventories somewhat slower than anticipated, and business capital spending continues to be cut back. Real GNP now seems to be bouncing around a low-point for this business cycle. The dramatic decline in interest rates recently and the upsurge in stock prices should prove helpful in firming business and consumer attitudes, and assist in avoiding a further deterioration in the economy. We continue to project a recovery in activity in coming months--a little later than had been expected--but with the same general composition as projected for some time and weak by historical standards. The incoming information on wages and prices seems consistent with our projections at the last meeting of the Committee, and we continue to project a further moderation in rates of increase in wages and prices.

In updating the forecast for this meeting of the Committee we altered the monetary and fiscal policy assumptions somewhat. On the monetary side, as a result of decisions at the last meeting growth of M1 is now assumed at 5-1/2 percent in 1982, 1/2 percentage point faster than we had assumed earlier. Interest rates associated with the assumptions and the forecast have been lowered, especially short rates and in the near term.

We have retained the assumption of slower M1 expansion in 1983 and expect that interest rates will be on the rise next year, although to levels that are a bit lower than we had anticipated previously. On the fiscal side, the implementation of the July tax cut led to a smaller reduction in withholding than had been expected and, therefore, a smaller immediate rise in disposable incomes; the revenue raising measures passed by the Congress were a little larger than we had been assuming, although the federal budget remains highly stimulative.

The information on employment, production, and sales that has become available during the past month or two generally has been on the weak side. The labor market surveys for July pointed to continued sluggishness in labor demands in the manufacturing sector, with some offset in growth of employment in finance and services. The unemployment rate rose 0.3 percentage point to 9.8 percent. Moreover, initial claims for unemployment insurance have been trending up in recent weeks, following declines earlier in the summer, and we anticipate a further increase in the unemployment rate in coming months.

For industrial production, the index declined only a tenth during July, a considerably better performance than earlier this year. Output of business equipment continued to drop at its recent pace--around 2 percent per month--while

production of defense and space equipment picked up as did output of consumer goods. A part of the rise in consumer goods output was associated with the auto sector where assemblies rose 12 percent in July. But the pickup in output and reduced sales led to a rise once again in auto inventories and production schedules have been cut back.

The auto sector doesn't appear to be alone in suffering from inventory problems. In particular, orders and shipments in the primary metals and nonelectrical machinery sectors have been so weak that inventories remain high despite aggressive cutbacks in production. Given the outlook for production and sales it appears that additional inventory liquidation will occur in the second half of this year, although at rates much reduced from those experienced early in 1982.

A key element suggesting persistent sluggish behavior of the economy in recent months has been weakness of consumer spending. In July, total retail sales reportedly rose 1 percent following a sharp drop in June. Auto sales rose a little in July but they remained quite weak in early August and qualitative reports on spending for other items do not suggest a major turnaround this month. Nevertheless, the sizable additions to disposable income from tax reductions and the social security increase in July are expected to provide support to growth of consumer spending.

Indicators of current and prospective business capital spending also have tended to be weak in recent months. Orders and shipments for producers durable equipment have taken the brunt of the near-term decline in spending, but commercial and industrial building activity has been slowing as well and oil and gas drilling activity has been sharply curtailed. Overall, it now seems likely that the cyclical decline in investment will be sizable and will take at least a year to run its course.

The residential construction area is a bit brighter and an area where we have not made significant changes to the outlook. Starts and permits rose in July, although they are obviously still at low levels. The recent decline in mortgage rates may give some upward impetus to real estate activity in coming months, but rates are not likely to be sustained at low enough levels to generate substantial activity. We have maintained the forecast of a mild cyclical recovery in the housing sector.

Overall, the forecast of real GNP still seems to have some downside risks associated with it in the near term. The signs of a solidly based upturn are not yet in hand, and there clearly are key areas of spending that could turn out worse than we now expect. At the same time, however, progress in eliminating the inventory overhang is being made, there have been considerable additions to consumer incomes recently,

and it doesn't take heroic spending expectations to generate what in reality is a weak cyclical recovery in the staff forecast.

That weak recovery carries with it substantial underutilization of labor and capital and this has been factored into our views on the likely performance of wages and prices. The recent evidence suggests we remain on the track of experiencing further moderation in rates of increase in both labor costs and product prices, and that portion of the staff forecast is essentially unchanged from the last meeting of the Committee.

[ad lib on CPI release due out Tuesday morning]

[Secretary's note: The CPI was reported to have increased at a 7.0 percent annual rate in July.]

The recent sharp declines of interest rates have brought short-term rates below their 1981 lows reached late in that year--in the bill area by from 1 to 2-3/4 percentage points, with the largest declines in the short bills. The 3-month CD rate is about 2 points below its 1981 low, and the prime rate is down by 2-1/4 points. The present short rate structure is still about 1 to 2 percentage points above the lows during the 1980 credit control period, though the funds rate in recent days has traded around the 9 percent level that it averaged in July 1980.

Recent longer-term rate movements have received almost spectacular publicity but, unlike short rates, the actual extent of decline has not been sufficient to bring them below 1981 lows. (In the bond market, the lows of 1981 were in the early not the late part of the year--rates having trended up in the course of the year). In fact, 30-year Treasuries and corporate bonds are still about 1/4 to 1/2 percentage point above these early '81 lows. They are not far below their 1980 highs, and well above 1980 lows.

While the bluebook for the previous FOMC meeting indicated that monetary aggregate specifications similar to those set by the Committee "could well produce a fairly substantial decline in money market rates," we did not, of course, predict as large a decline as in fact occurred. The greater extent of decline reflects a somewhat weaker economy than had been projected but also, and more particularly at least in my view, a stronger demand for liquidity by certain sectors of the economy than we had anticipated and a developing expectation that the Federal Reserve would be accommodative to such demands, as evidenced by three successive cuts in the discount rate.

The strong drive for liquidity is reflected in the public's asset holdings by sizable recent increases in M2, although these may in part just be a temporary repository for funds available from the tax cut. The liquidity demands are probably also reflected in sharp drops in rates on very short-term instruments, such as Fed funds and RPs, as the financial difficulties of certain major banks, a few dealers, and large borrowers from banks encouraged many money market lenders to be cautious in provision of their funds by making them available only at very short-term. This caution has also produced some tiering in these markets and in the CD market. Business firms have also shown a continued strong preference for holding liquid assets rather than inventories.

A major issue for the Committee of course is whether current yield levels--short as well as long-term--are adequate for a satisfactory economic recovery. The expansionary power of current rate levels depends in part on expectations held by market participants of future rate levels and of inflation as well as on the strength of demands for goods and services as influenced in part by that intangible called confidence.

With regard to confidence, it may well be at a relatively low ebb. Failures and near failures of major business firms and financial institutions in this country and around the world are not helping. The debts of less developed areas and of major industrial corporations have become more and more burdensome to them, and as markets around the world show considerably less vitality than might have been hoped for, large borrowers tend to adopt contractionary policies that may not be easily reversed.

Under the circumstances, it is not clear that the present interest rate structure provides a very strong incentive toward economic expansion. The 3-month Treasury bill rate and Federal funds rate are relatively low largely because of investor caution. The steep slope of the yield curve out to 1 or 2 years suggests that the market presently views these relatively low short-term rate levels as temporary and hence that borrowers would be confronted with considerably higher fund costs over any reasonable planning horizon than is suggested by rates in the 3-month or shorter area. As noted earlier, bond yields are still just above their 1981 lows and not far from their 1980 highs. Moreover, short-term rates to private borrowers are high relative to prevailing Federal funds and Treasury rates in view of concerns about credit quality. Thus, if you take the view that prospects for containing inflation over the long-term are much better than in late 1980 or 1981, and also feel uncertain about the state of business and consumer confidence, the present interest rate structure would still seem to imply quite high real borrowing rates relative to expected real returns.

These rate levels are being produced with the narrow money stock so far running under the short-run target for June to September set at the previous Committee meeting and with M2 running above. If interest rates are indeed unduly high in real terms, either they will come down as investors realize this and sharply increase demands for longer-term instruments, or they will come down as borrowers refrain from spending and the economy weakens. Our staff GNP forecast treads what might be termed something like a middle ground, not promising much of an economic recovery but not promising lower rate levels either.

The policy alternatives for the aggregates presented for today's discussion are projected to involve rising interest rates, if not sooner then later, given our GNP outlook. A choice among the two alternatives would be to choose the alternative with higher money growth rates (i.e. alternative A), perhaps with an eye to fostering growth around the top of, or possibly slightly above, the longer-run range for the year. However, this alternative runs the greater risk of whipsawing credit markets in part because it implies relatively rapid near-term rates of M1 growth that might work against dampening inflationary expectations, particularly if the economic news begins to brighten.

Alternative B contemplates somewhat lower near-term money growth than A, and would presumably also involve higher interest rates over the near-term if the economy is in the process of strengthening about as projected. However, if the economy is weaker than projected, this alternative also would provide scope for maintaining something like the relatively easy credit market conditions that have come to prevail recently, without raising as much risk as alternative A that the market will react adversely to what might be viewed as excessive money expansion. This alternative also would provide somewhat more scope for money expansion in the fourth quarter when private credit demands may well be strengthening.

One compromise approach between the two would be to stick with the existing short-run target of alternative A, but accept an outcome like B provided it was consistent with some decline in rates or at least no significant near-term rise. In implementing policy, it should be pointed out that, assuming borrowing at the discount window is at least at frictional levels, the present discount rate may not be consistent

with a policy approach that has the intent of averting a near-term back-up in short-term rates, or at least a significant back-up, unless actual money growth begins to come in weaker than the track set by the Committee. On the other hand, if actual money growth is considerably weaker than the track set by the Committee, there is also the risk that money market rates could drop precipitously if very sizable excess reserves numbers are implied by a literal reading of the paths in weeks when required reserves turn out to be quite a bit weaker than anticipated.